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IN THE  
**United States Court of Appeals**

FOR THE NINTH CIRCUIT

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**No. 16,823**

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ESTATE OF WALTER F. RAU, SR., deceased, RAYMOND J.  
SHORB, Administrator with the Will Annexed, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

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Petition for Review of Decision of the Tax Court  
of the United States

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REPLY BRIEF FOR PETITIONER

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**PRELIMINARY STATEMENT**

Respondent filed its brief in this proceeding under date of September 9, 1960. This brief, in behalf of Petitioner, is in reply thereto.

Without conceding other arguments advanced by Respondent, Petitioner's reply will be directed to the substantive aspects involved herein.

### Reply to: Summary of Argument

Notwithstanding the adoption thereof by the Tax Court, Respondent's characterization of oral testimony as "specific adjustments" is not only novel but it also lacks the judicial approval that has been accorded the net worth method upon which Petitioner relies in support of its position. Respondent ingeniously endeavors to justify its position in this regard by referring to the deficiencies resulting from the net worth method; apparently, so it seems, Respondent seeks to persuade this Court that this latter method is less reliable than the unsubstantiated oral testimony of Webb and Goldstein; the fact that the net worth method reflects deficiencies does not, in and of itself, warrant its rejection in favor of the oral testimony of Webb and Goldstein. Assuming, *arguendo*, that such justification existed, it cannot endure when consideration is given to the unusual personal financial transactions of Webb and Goldstein as demonstrated by the record.

Respondent's argument (B. 14) that the net worth statement shows a consistent pattern of under reporting income in all the taxable years before this Court is clearly erroneous; the net worth, as stipulated, reflects over reporting of income for the years 1946 and 1947 (Pet. App. 42).

### Reply to: Argument

#### I

Petitioner does not dispute the rule of law announced in the cases of *Helvering v. Nat. Grocery Co.*, 304 U.S. 282; *Helvering v. Taylor*, 293 U.S. 507; *Goe v. Commissioner*, 198 F. 2d 851 (C. A. 3d), certiorari denied, 344 U.S. 897; *Snell Isle, Inc. v. Commissioner*, 90 F. 2d 481 (C. A. 5th), certiorari denied, 302 U.S. 734, cited by Respondent. Petitioner, however, does dispute the applicability of those decisions to the facts under review; Petitioner employed a method in determining income that has a long history of judicial approval as opposed to a means

not heretofore recognized or accepted as a method. The mere fact that the Tax Court found that the net worth method was less reliable than the oral testimony of two former employees does not, it is submitted, preclude the Petitioner from questioning the findings of that Court. This Court is vested with the power and authority to review and to set aside a finding which is clearly erroneous; indeed, this is the very essence of this review. It is Petitioner's contention that this finding of the Tax Court is not only clearly erroneous within the meaning of Rule 52(a), Federal Rules of Civil Procedure, but it is also arbitrary and capricious and is contrary to the law and the evidence.

Petitioner has no quarrel with the principle of law relating to the opportunity of the Trial Court to appraise the credibility of witnesses and is in full accord with such principle as expressed in the cases of *U. S. v. Gypsum Co.*, 333 U.S. 364, rehearing denied, 333 U.S. 869; *Baumgardner v. Commissioner*, 251 F. 2d 311 (C. A. 9th); *National Brass Works v. Commissioner*, 205 F. 2d 104 (C. A. 9th); *Ferrando v. U. S.*, 245 F. 2d 582 (C. A. 9th); *Staudt v. Commissioner*, 216 F. 2d 610 (C. A. 4th); *Hague Estate v. Commissioner*, 132 F. 2d 775 (C. A. 2d), certiorari denied, 318 U.S. 787.

In this regard, however, Petitioner questions the right of the Tax Court to abuse its discretion in appraising the credibility of witnesses whose trustworthiness and integrity have been seriously impugned by virtue of their highly suspicious personal financial transactions; even the Court below observed that Petitioner had generated "smoke" in that connection (R. 256); assuming, further, that Petitioner had only generated "smoke" relative to the possible defalcation of Decedent's funds in endeavoring to disclose the disposition thereof, is it not inconsistent to characterize the testimony of Webb and Goldstein as being "credible, consistent, powerful and persuasive"?

In criminal proceedings, it is well recognized that the testimony of an accomplice is subject to strict limitations

as to the credibility thereof; while the present proceeding is civil in nature, we have the admission of both Webb and Goldstein that they knowingly participated in the alleged falsification of records and, as to Goldstein, she admitted that she knowingly prepared the Decedent's income tax returns knowing them to be false at the time; these acts were performed by these individuals over a period of six years. Such conduct constitutes a felony under the provisions of Section 3793(b)(1), Internal Revenue Code, 1939; the fact that Webb and Goldstein testified that they were "instructed" to commit these felonies must, under the circumstances, be regarded as nothing more than self-serving declarations; it is incredible that two individuals, approximately forty years of age, would aid and abet the commission of a crime, year after year, while receiving a salary of \$100.00 per month, in the case of Webb, and \$10.00 per month in the case of Goldstein.

Under such conditions, it would seem that Respondent is not above criticism in predicating its determination of income on the testimony of two such individuals.

Respondent claims that the crux of Webb's and Goldstein's testimony related to the control which Decedent exercised over the conduct of his businesses (B. 16); while this might have been the crux of their testimony, that fact does not lend support to their credibility. Betty Dorsey, a witness called on behalf of Petitioner, was Decedent's practical nurse from the latter part of 1945 until his death in January, 1953; this witness testified that Decedent was not mentally alert or sharp; that Decedent was in poor health and devoted little time to his businesses (R. 539-563). The extent of Webb's control and his exercise of authority in the conduct of Decedent's businesses was commented upon by Respondent in its brief (B. 5-8). It is difficult to reconcile this portion of Respondent's brief with the fact that the Decedent, who was addicted to the excessive use of alcohol, in poor physical health, unable



to dress and undress himself, not mentally alert, subject to spells of weeping, was obviously incapable of close supervision in the conduct of his businesses; it is an undisputed fact that Webb and Goldstein were entrusted with the Decedent's several businesses and this fact cannot be avoided by accepting the testimony of Webb and Goldstein to the effect that Decedent was mentally sharp and that he exercised close supervision; the evidence overwhelmingly establishes that Webb and Goldstein dominated and controlled Decedent's businesses.

Respondent argues that Petitioner failed to offer any evidence whatsoever to substantiate the possible embezzlement of Decedent's funds by Webb and Goldstein (B. 17); in view of the very nature and extent of the financial transactions of Webb and Goldstein, keeping in mind Webb's salary of \$100.00 per month and Goldstein's salary of \$10.00 per month, and the nature of their duties, day and night, it is, quite frankly, incredible that Respondent would advance such an argument. Respondent has, it is submitted, secured numerous convictions for tax evasion on just this kind of evidence.

At this point, it is well to comment upon another fact about which Respondent has remained remarkably silent; specifically, it concerns Webb's testimony in connection with a check in the amount of \$3,500.00 drawn by him and payable to cash or to himself; according to Webb, the check was drawn in 1942 and related to the purchase of a home by the Decedent located at 318 F Street, Bakersfield, California. Webb was very positive as to the year in which this transaction occurred; the net worth, however, as stipulated between the parties, reflects the purchase of this home at least by 1941 (R. 181-183). Once again, as in the case of the checks contained in Exhibit 14, Respondent has utterly failed to demonstrate that Decedent received the benefit of this check; Respondent has likewise failed to present any explanation for such highly

questionable transactions and has permitted the contradictions to remain unexplained. The record is completely devoid of any evidence relative to the final disposition of the sum of \$3,500.00 represented by the check in question; the evidence merely shows that Webb received the proceeds, and nothing more.

Respondent seeks to refute Petitioner's contention relative to the whereabouts of Decedent's funds in excess of the net worth by injecting the question of inventories. While the purpose of Respondent in so doing is quite obvious, Petitioner has never contended that Webb and/or Goldstein derived any benefit by means of incorrect opening and closing inventories; Petitioner has contended, however, and still insists that Webb and Goldstein could very well have embezzled funds from their employer by means of the checks drawn to cash purportedly representing cash payments for supplies; Respondent cannot deny that all of such checks, over a period of six years, were drawn by Webb, in his handwriting, and that they were cashed by him at the bank for the alleged purpose of paying for supplies delivered to the French Cafe or to the Southern Wine and Liquor Bar. Petitioner claims that, unless Decedent, an alcoholic, weak and infirm, examined every invoice and reconciled the checks issued therefor, he could not possibly detect defalcations of his funds by Webb and Goldstein; at this juncture, it is interesting to observe that Respondent's brief is startlingly silent as to the final disposition of the funds obtained by Webb represented by the checks drawn by him to "cash"; specifically, Petitioner has reference to Exhibit 14 containing a group of checks bearing Decedent's name as drawer as well as endorser, both of which were inscribed by Webb himself; a listing of these checks appears on Page 32 of Petitioner's original brief. The principles of "fair play" impose upon Respondent the obligation of explaining the final disposition of these funds; the opportunity for so doing presented itself at the hearing and has persisted throughout the entire pro-

ceeding; as yet, however, Respondent has failed to offer any forthright explanation; these funds have never been traced to the possession of anyone other than Webb; nor, indeed, did Webb state that he gave the funds, represented by these checks, to Decedent at any time. Petitioner has presented direct evidence that unequivocally establishes that Webb was the only one who obtained the funds. It is elementary arithmetic, that, until Respondent demonstrates by probative evidence that these funds were returned to the Decedent, they cannot be taxable to Decedent.

With respect to Respondent's argument that Petitioner has intended to confuse Webb's testimony with respect to the envelopes containing alleged withdrawals (B. 18), Petitioner does not regard this as a matter of substance and relies upon the record in support of the contention that Webb's testimony is not only confusing as to the whereabouts of the funds which he received from the bartender at the French Cafe, but that, in the main, his testimony in this regard is contradictory as well; by way of comment, Counsel for Respondent at the hearing indicated his own confusion when he stated, "that this money was then laid there and Mr. Rau examined that together with the money in the envelope" (R. 174); Respondent also argues that Webb's and Goldstein's testimony has been taken out of context by Counsel for Petitioner; Respondent, however, fails to particularize an instance of this kind and, consequently, Petitioner is denied the opportunity of presenting an intelligent reply to such an argument.

Except for Respondent's argument relating to the issuance of checks to cash, the other arguments remaining under Part I of Respondent's argument do not involve substantive aspects and from the nature of such arguments, it is apparent that Respondent seeks to extricate its witnesses from their own web of confusion and contradictions. Respondent's argument that Webb's testimony with regard

to the issuance of checks "clearly establishes that Decedent instructed Webb to make checks out to cash . . ." (B. 18), is quite unique; first of all, in making the assertion, Respondent is obliged to rely upon Webb's testimony; this, in itself, in Petitioner's opinion, has little to recommend itself. As a matter of fact, Respondent's case depends upon the credibility of Webb and Goldstein plus the rejection of the net worth which was compiled from unbiased third party sources and agreed to by Respondent.

## II

Respondent cites Section 41, Internal Revenue Code, 1939, whereby the Commissioner is authorized, in certain instances, to make computation of income in accordance with such method as "in the opinion of the Commissioner does clearly reflect income" to support the acceptance of oral testimony of Webb and Goldstein; it is here, that Petitioner vigorously objects to the designation assigned by Respondent to such oral testimony. Not one of the cases cited by Respondent in this connection involves facts remotely resembling those under review: *Halle v. Commissioner*, 7 T.C. 245, 250; affirmed 175 F. 2d 500 (C. A. 2d), certiorari denied, 338 U.S. 949; *Miller v. Commissioner*, decided April 29, 1955 (1955 P-H T.C. Memorandum Decisions, par. 55, 122), affirmed on this point, 237 F. 2d 830, 838 (C.A. 5th); *United Dressed Beef Co. v. Commissioner*, 23 T.C. 879, 885; *Funk v. Commissioner*, 29 T.C. 279, 293, affirmed *sub. nom. Furnish v. Commissioner*, 262 F. 2d 727 (C.A. 9th); *Schira v. Commissioner*, 240 F. 2d 672 (C.A. 6th); *Stone v. Commissioner*, 23 T.C. 893, 904; *Schellenburg v. Commissioner*, 21 T.C. 1269. Apparently, Respondent relies heavily upon the decision in *Schellenburg v. Commissioner, Supra*, and quoted, in part, the decision of the Tax Court in that case (B. 21-22); the facts in *Schellenburg v. Commissioner, Supra*, are so unlike those in the instant proceeding that they admit of no similarity whatsoever; in the Schellenburg case the evidence clearly demonstrated

specific instances of omissions of sales based on the records of the Petitioner in conjunction with the records of the purchasers to whom the sales were made; the actual omission of sales and the failure of the Petitioner, in that case, to record them in his records was, therefore, established by the evidence. In the present proceeding, we have only the allegations of two employees that receipts were withheld; there is no evidence, whatsoever, showing that they were not ultimately deposited in Decedent's bank accounts or used in the acquisition of assets; furthermore, there is most potent evidence that the so-called, withheld receipts, found their way into the possession of Webb and Goldstein. It is well to refer to that part of the Tax Court's opinion in *Schellenbarg v. Commissioner, Supra*, which Petitioner believes to be of sufficient importance to be set forth verbatim herein:

“... It is apparent that the choice as to the method of reconstruction to be employed lies with the Commissioner, and not the taxpayer, *the only restriction being that the method adopted be reasonable.*” (Italics supplied).

It will be observed that the authority granted to the Commissioner under Section 41, Internal Revenue Code, 1939, is not an absolute, unrestricted power; the method adopted must be *reasonable*.

Respondent argues in support of the Tax Court's findings that the so-called “specific items” of understated income furnished a more accurate guide to the computation of Decedent's income than the net worth method; it attempts to substantiate this position by referring to the existence of a safety deposit box maintained by the Decedent and by claiming that Petitioner's query as to the whereabouts of the sum of \$131,000.00 is readily answerable by the fact that the contents of the safety deposit box were not included in the net worth computation; this argument, of course, is not only facetious but disregards and

ignores actual facts; upon the death of the Decedent, the Administrator examined the contents of the safety deposit box and made an accounting to the Probate Court whose records were available to Respondent's agents as well as to Petitioner who examined them in compiling the net worth; no such funds were contained in Decedent's safety deposit box. If, as Respondent represented to the Court below, it stipulated to the net worth only for the purpose of corroborating the testimony of Webb and Goldstein, the use of the Administrator's report was available for such purposes.

Respondent claims that Petitioner obviously overlooks the fact that the net worth technique of computing income is not a method of accounting. How, it is asked, has Petitioner regarded the net worth as a method of accounting in this proceeding? All that Petitioner has done is to adopt the net worth method of determining taxable income rather than accepting the highly questionable testimony of Webb and Goldstein; nowhere, has Petitioner claimed that the net worth method constitutes a recognized method of *accounting*. The cases cited by Respondent in support of his contention, therefore, are of academic interest only and can serve no useful purpose in this controversy.

The Tax Court's determination of deficiencies may be tested by still another approach; in its decision, the Court below increased Decedent's income from the French Cafe and the Southern Wine and Liquor Bar and also reduced the cost of goods sold as to both of these operations; by so doing, a most interesting result is obtained; the following tabulation reflects comparatives of percentages as to *net profit*, compared with those compiled by the Treasury Department of the United States with those resulting from the adjustments effected by the Tax Court:

Year	Treasury Dept. Statistics National Average	Per Tax Court Findings
1942	5.0	24.02
1943	6.63	32.93
1944	5.28	24.35
1945	5.96	19.37
1946	5.98	26.83
1947	4.88	45.00

## III

Respondent cites several cases in support of its claim that the findings of the Tax Court, as to fraud, will not be disturbed on appeal if such findings are supported by clear and convincing evidence; Petitioner agrees with this well recognized principle of law but, however, disagrees with the finding that the facts herein are clear and convincing within the meaning of the cases upon which Respondent relies; first of all, the evidence itself, oral testimony, does not, as a matter of law, constitute clear and convincing evidence; to meet that definition, such testimony must be credible and reliable. Petitioner has, it is submitted, unquestionably demonstrated the incredibility and unreliability of the oral testimony upon which the fraud penalty has been predicated. It is equally well recognized that a deficiency, by itself, does not constitute clear and convincing evidence justifying the imposition of the fraud penalty. *Kerbaugh, Henry S.*, 29 B.T.A. 1014; aff'd. 74 Fed. 2d 749, C.A. 1 (1939); *Nicholson v. Commissioner*, 32 B.T.A. 977 (1935), aff'd. 90 Fed. 2d 978; *Schultze, William J.*, 18 B.T.A. 444 (1929); *Switzer, L. Glenn*, 20 T.C. 759; *Wiseley v. Commissioner*, 185 Fed. 2d 263, reversing 13 T.C. 253.

The alleged falsification of Decedent's records is based upon extremely tenuous explanations of two witnesses, viz. that they were "instructed" to do so; such an explanation is patently self-serving and consequently is of insuffi-

cient weight to constitute clear and convincing evidence within the judicial meaning thereof.

When this proceeding is viewed in its entirety, and painted with a "broad brush", not even a trace of fraud remains.

#### IV

In its opinion, the Tax Court observed that the issue of the survival of the fraud penalty was raised by Petitioner in its brief but that it had not been raised in the pleadings; the Tax Court, therefore, held that this issue was not properly before it. The Rules of the Tax Court do not provide for the raising of legal arguments in the petition. Rule 6 of the Rules of Practice, Tax Court of the United States.

Under the Rules of the Tax Court, the petition must contain assignments of error which Petitioner alleges to have been committed by the Commissioner in the *determination of the deficiency*; it must also contain a concise statement of facts upon which Petitioner relies in support of the assignment of errors. It is obvious of course, that Decedent was deceased prior to the mailing of the Statutory Notice of Deficiency; the statute of limitations was pleaded and the Petitioner prayed for such further relief as the nature of the case may require; the petition contained allegations as to the date on which Decedent's income tax returns were filed and the petition, itself, was filed in the name of the Administrator of Decedent's Estate; the issue of the survival of the fraud penalty is exclusively a question of law involving the construction and interpretation of legislative enactments. In its discretion, the Tax Court could have taken cognizance of the issue at the time it was presented by the Petitioner in its brief; based on the foregoing facts, the failure of the Tax Court to consider this issue constitutes an abuse of discretion and likewise constitutes reversible error. Furthermore, Respondent, in its



brief, filed with this Court, has presented opposing arguments on this issue; having done so, Respondent has waived its rights and this Court has jurisdiction to review all such matters.

### CONCLUSION

For the reasons herein set forth and for those contained in Petitioner's original brief, the decision of the Tax Court should be reversed and the Tax Court should be directed to reach a decision based upon the law and the evidence.

Respectfully submitted,

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